Pole position

Quarterly Letter

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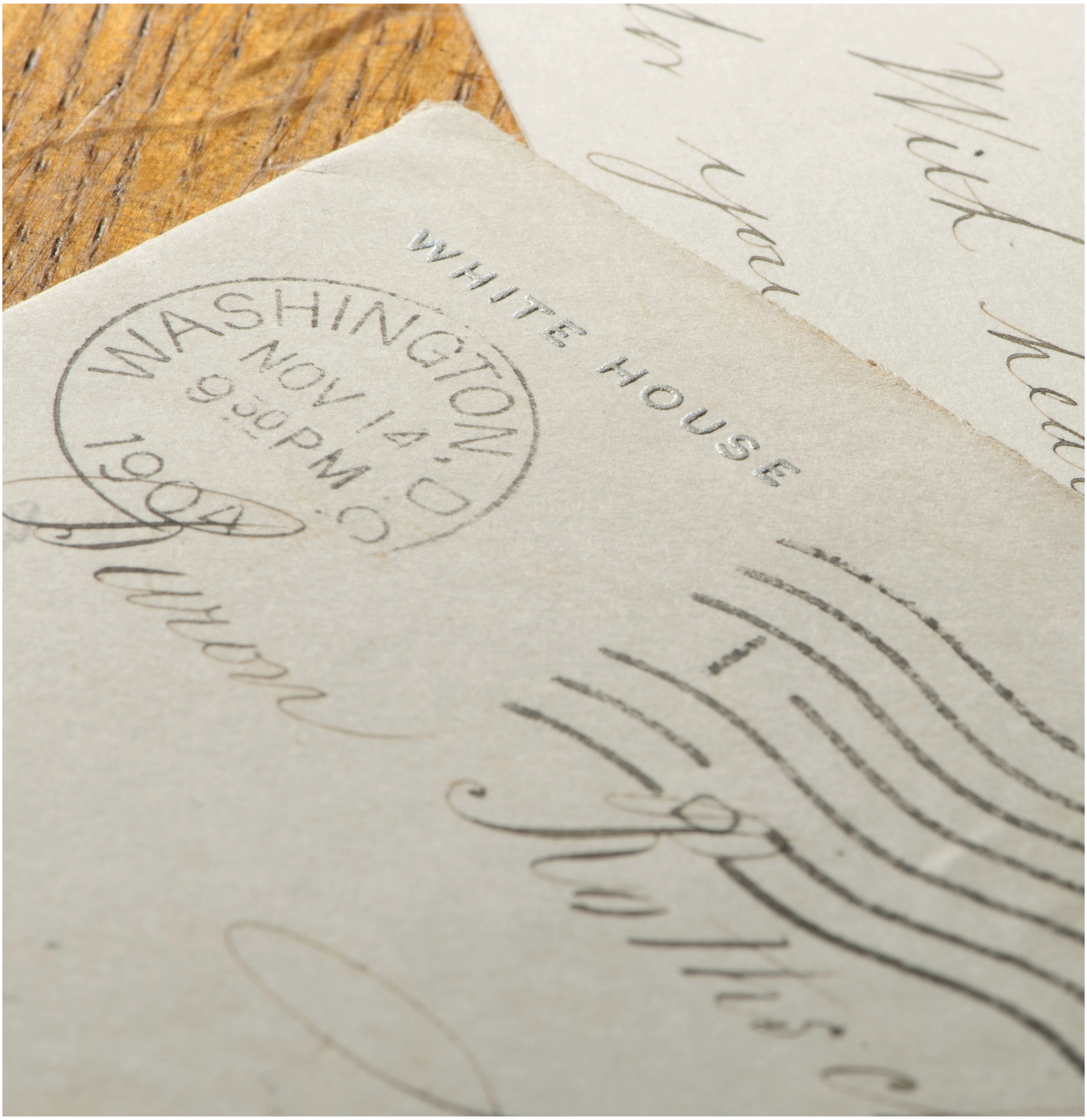


Rothschild & Co
Wealth Management

Foreword

More than 20 million Brits tuned into the BBC's coverage of Usain Bolt winning the 100 metres at London 2012. Last year's FIFA World Cup final was watched by more than 1 billion people. And half of the world's population watched at least part of the Rio Olympics in 2016.

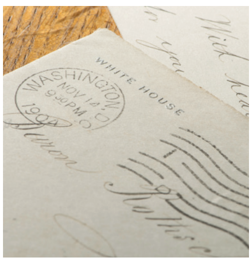
Humans are clearly passionate about sport, but it's more than that; we love winners, and this isn't a recent development. The first Olympic Games in Ancient Greece took place nearly 2,800 years ago. Pitz, a sport played by the Mayans as far back as 2,500 BC is thought to be the first ever ball game. Even prehistoric cave paintings appear to show people participating in wrestling, swimming and archery.

Much has changed since then, but our love of competition has stayed the same. We celebrate and commemorate athletes who compete against the best challengers and emerge victorious time and time again. History isn't usually as kind to those who place second. After all, can you remember the runner-up in any of the races where Usain Bolt has won a gold medal?

Sports may have been around for thousands of years, but we can often pin down timeless characteristics that signal long-term success for an athlete – confidence, discipline, motivation, resilience and, of course, natural ability. Success in business is remarkably similar. There are sustainable competitive advantages that help the very best companies maintain a reliable edge over rivals, despite market fluctuations, shifts in consumer trends, disruptive technologies and other unpredictable factors.

In this *Quarterly Letter*, we explore the similarities between competitive advantages in sport and business through the specific lens of Formula One (F1). In doing so, we hope to shine a spotlight on how our investment approach helps us preserve and grow your wealth.

Helen Watson
CEO, UK Wealth Management



Cover image:
Envelope from a Presidential 'Thank you' sent to Nathaniel 1st Lord Rothschild (1840–1915), Senior Partner N M Rothschild & Sons, from President Theodore Roosevelt (1858–1919) in 1904. Courtesy of The Rothschild Archive

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Pole position

Finding the winning Formula for sustainable competitive advantage

"One must keep working continuously; otherwise, one thinks of death."

In today's constantly shifting commercial environment, the words above feel particularly true. The business landscape is a graveyard of missed opportunities, inhabited by former industry giants that were too slow to innovate and eventually failed altogether. You don't have to look too far to see the aftermath of this complacency. Toys 'R' Us, Woolworths and – most recently – Thomas Cook, to name just a few, have all fallen into administration over the last 10 years despite decades of prior success.

The quote itself is attributed to Enzo Ferrari, the Italian motor-racing driver who founded the Scuderia Ferrari Grand Prix team. Enzo may not have been an esteemed economist or philosopher, but his words perfectly encapsulate a timeless reality of business: evolve or die.

At first glance, F1 may seem an unlikely source of inspiration for understanding how the best businesses succeed over the long term. After all, a key measurement of a company's performance is profitability, and F1 teams struggle to break even most seasons and routinely report financial losses. Success in motor racing is judged on wins, whether it's Grand Prix results, Constructors' Championships or Drivers' Championships. Teams spend as much as they can afford in the race towards coveted podium places.

Take a look under the bonnet, however, and we quickly see the fundamental mechanics behind long-term success are similar in both F1 and business. Before we can identify a winning formula for companies, we must first delve into the theory behind economic competition, particularly the notion of sustainable competitive advantage.

Putting yourself in the driver's seat

The topic of sustainable competitive advantage has been comprehensively studied in recent decades, as businesses strive to maintain an edge over rivals.

Distinguishing between competitive advantage and *sustainable* competitive advantage is important. For example, lowering prices can help a company temporarily overtake its competitors. But this is a fleeting victory, as rivals will soon match the new price and catch up, creating a race to the bottom where everyone loses. UK grocery prices fell consistently between September 2014 and December 2016, as the Big Four supermarkets – Tesco, Sainsbury's, Asda and Morrisons – battled to stem the flow of customers shopping at discount stores Lidl and Aldi. All four also launched schemes that promised to match competitor pricing if consumers could find products cheaper elsewhere. As of September 2019, the Big Four are still losing ground to Aldi and Lidl and they have dropped their price-match promises.

Instead, sustainable competitive advantages are enduring and evolving attributes that a company can consistently rely upon to achieve and maintain a market-leading position. In 1999, Warren Buffett popularised the term 'economic moats' to describe a business's ability to protect itself from external threats through competitive advantages.[1] Similar principles were explored even earlier in economist Joe S. Bain's seminal 1956 work *Barriers to New Competition*, while economic competition theories can be seen as far back as 1776 in Adam Smith's magnus opus *The Wealth of Nations*.

Whether you prefer moats or barriers, they must be wide or high enough, respectively, to prevent rivals from gaining ground. In the words of Buffett himself[2]:

"If you've got a wonderful castle, there are people out there who are going to try and attack it and take it away from you. I want a castle that I can understand, but I want a castle with a moat around it."

Investment research firm Morningstar has defined the key sustainable competitive advantages that provide companies with an economic moat, which include[3]:

- Intangible assets
- Cost advantage
- Switching costs
- Efficient scale

1. https://archive.fortune.com/magazines/fortune/fortune_archive/1999/11/22/269071/index.htm

2. https://www.youtube.com/watch?v=eRlQfS__u7E

3. http://www.morningstar.com/InvGlossary/economic_moat.aspx

We're keen for our readers to gain valuable insight into how the concept of sustainable competitive advantage helps influence the investment decisions we make here at Rothschild & Co. With this in mind, we feel the world of F1 and the story of Ferrari, in particular, provide examples of Buffett's 'moats' in action.

Intangible assets: A driving force behind innovation and brand

As the name suggests, an intangible asset is one that lacks physical substance. Common examples include intellectual property – such as patents, copyrights and trademarks – and brand recognition, which can limit competitors' abilities to replicate a company's products or services.

Within F1, Ferrari arguably has the best set of intangible assets. The team's fortunes may wax and wane, but it is safe to say they have never pumped the brakes when it comes to innovation and branding.

Racing puns aside – for now – Ferrari is the world's most recognisable and successful F1 team, with a record number of Grand Prix wins, Constructors' Championships and Drivers' Championships. Ferrari's 'Prancing Horse' logo is renowned even among motorsports novices, and the team is so popular that its fans have their own nickname – The Tifosi. Ferrari ranked as the world's strongest brand in 2019, overtaking McDonald's, Coca-Cola, Lego and Disney.[4] The company is synonymous with style, performance and sophistication, allowing the manufacturer to move beyond the automobile industry into merchandising, theme parks and even hospitality, with the Ferrari-themed hotel, Maranello Village.

Patenting is difficult to pin down in F1, with many teams instead relying on trade secrets rather than going through the lengthy and complex process of gaining official worldwide patents on innovations. Nevertheless, research and development (R&D) at Ferrari has led to a number of engineering breakthroughs, such as high-performance engines, traction control systems, aerodynamics designs, lightweight carbon fibre parts and kinetic energy recovery systems.

While many of the companies that we invest in also possess strong intangible assets, Deere is perhaps among the best examples of a firm with a phenomenally strong brand underpinned by constant innovation.

Famous for its iconic green equipment, Deere is regularly included in Fortune Magazine's list of the World's 50 Most Admired Companies, and customers rank the business as more innovative than tech giants such as Facebook and Google.[5] Deere's dedication to R&D-led product improvements, supported by patents, has helped the company collect an impressive haul of innovation awards over the years, including six industry awards for outstanding innovation in 2019 alone.[6] The company also goes the extra mile and celebrates creative thinking within its supplier network, launching the John Deere Supplier Innovation Awards in 2010 to reward cutting-edge products and services.

Structural cost advantages have long been acknowledged as a reliable moat upon which to preserve and grow a business's competitive advantage.

We are confident that these and other barriers to entry will help Deere maintain its market-leading position, which has seen the operating margins for the company's equipment division outperform the sector average for the last 15 years. Both Deere and Ferrari also share an appreciation for continuity – in 180 years, the former has had just nine CEOs, while the latter is the only F1 team to have competed every year since the beginning of the sport.

Cost advantage: Avoiding the money pit

Structural cost advantages have long been acknowledged as a reliable moat upon which to preserve and grow a business's competitive advantage. They allow a company to undercut rivals on price while maintaining similar profit margins, or – alternatively – earn high margins when matching prices.

But how does this relate to F1? Particularly as teams rarely try to create cost efficiencies. Quite the opposite in fact – the bigger the budget, the more success a manufacturer is likely to achieve within a season. Ferrari has traditionally been the sport's biggest spender, yet the money seems to have been well spent. The manufacturer has clinched 16 Constructors' Championships over the last 60 years – nearly double Williams, which sits in second place with nine titles.

However, this doesn't mean efficiencies are irrelevant in F1. You instead have to examine one of the sport's most nail-biting features to better appreciate sustainable competitive advantage: pit stops. For just a few seconds during every race, F1 vehicles park up while as many as 20 pit crew swap tires, make adjustments, clean and, if required, perform repairs.

4. https://brandfinance.com/images/upload/global_500_2019_free.pdf

5. https://johndeerejournal.com/2018/10/mostinnovative/

6. https://www.deere.com/en/our-company/news-and-announcements/news-releases/2019/agriculture/2019jan10-john-deere-earns-six-ae50-awards/

Quicker pit stops result in less time off the track, meaning drivers can avoid being overtaken. Shaving off valuable seconds, or even tenths of a second, can be the difference between Grand Prix success and failure. The DHL Fastest Pit Stop Award recognises the best in the business, and Ferrari clinched the inaugural title in 2015 after posting the fastest pit stops at seven of the first 18 races of the season. Ferrari uses the latest technology, operational efficiency and effective management to minimise pit stop times without sacrificing performance.

Within our portfolio, Ryanair has relied on similar techniques to become the most successful low-cost, high-volume airline in Europe. The company's remarkable focus on cost, combined with significant negotiating power with suppliers and service providers, means it has the lowest average fares and costs per passenger in the sector, while still maintaining the highest net margins.

Within our portfolio, Ryanair has relied on similar techniques to become the most successful low-cost, high-volume airline in Europe.

Ryanair's average fare is currently €37, whereas its costs per booked passenger stand at just €29. Even other low-cost airlines struggle to compete with these figures. For example, easyJet has an average fare of €61, which is 65% higher than Ryanair. Costs tell a similar story, with easyJet averaging €53 per passenger (+83% versus Ryanair).

The cost advantage is clear, but what makes Ryanair's competitive edge sustainable? Sports scientist Stafford Murray found that gaze patterns are the defining factor in pit stop efficiency. Vision-tracking goggles showed the slowest pit crew mechanics would spend most of their time looking at the sky, other colleagues and – often – their own feet as the vehicle approached the stop. The best-performing pit crew always had their eyes on the prize; they were completely focused on the car's tires and wing nuts to ensure they were well-prepared to fulfil their objective.[7]

We feel Ryanair's management team, particularly CEO Michael O'Leary, have a similarly keen eye for revenue-generating opportunities and cost reductions. They also demonstrate a dogged commitment to creating shareholder value that mirrors the laser focus exhibited by the best pit stop crews.

Switching costs: On your marks, get set... stay

Michael Schumacher is widely regarded as the best F1 driver of his generation and one of the all-time greats. He won a record seven World Championships, possesses the most Grand Prix wins (91), the most races won in a single season (13) and the highest number of fastest laps (77).

With Ferrari, Schumacher won five consecutive World Championships between 2000 and 2004. The Italian manufacturer and the German driver appeared to have the perfect partnership. However, Schumacher retired in 2006, and Ferrari has struggled to hit a rich vein of form since. The team has secured just one Drivers' Championship and two Constructors' Championships in the last 15 years, the last of which was in 2008.

Ferrari's decade-long trophy drought not long after Schumacher's departure is a good illustration of switching costs at play. When switching away from a particular product or service becomes too complicated, expensive or time-consuming for consumers or businesses, the supplier of that product or service benefits from switching costs. Better pricing power and customer retention are commonly the result, creating a strong, sustainable competitive advantage.

When an F1 driver wants to move teams, or a manufacturer wants to bring in a new driver, both parties have to consider how switching costs will impact performance. F1 teams build a unique dynamic over many seasons. Drivers spend endless hours learning a vehicle's distinct advantages and limitations. They develop a strong camaraderie with their pit crew and management team. All of this hard work, experience and team spirit can be jeopardised by moving to another manufacturer where they have to start from scratch. Similarly, the loss of top talent for F1 teams often has a detrimental effect not only on results, but also sponsorship deals and fanbases in a sport where supporters can be more loyal to their favourite drivers than manufacturers. Teams may also have to adapt infrastructure, R&D focus and staffing to ensure a good fit with an incoming driver.

Identifying a company in our holdings that benefits from similar market dynamics isn't difficult. Industrial gas supplier Praxair had a firm grip on the steering wheel when it came to switching costs, possessing long-term contracts with clients that lasted up to 20 years. The company also uses take-or-pay contracts with

7. Medeiros, Joos. Game Changers: How a Team of Underdogs and Scientists Discovered What it Takes to Win guaranteed cost passthrough. But Praxair's fundamentals were built on more than just legal documentation. In our view, the company's best-in-class management offered superior strategic benefits to competitors, with a strong focus on cost control and generating returns.

And while refuelling during races was banned in F1 from 2010 onwards, Praxair prided itself on a zero-tolerance approach to gas supply failures, driving home a reputation for consistency and reliability that ensured clients didn't just have to stay with the firm, they wanted to. This was clearly reflected in performance. Between 2008 and 2016, Praxair's profit margin was 31% versus a 24% peer average, while return on capital stood at 11.3%, comparing favourably with the 8.5% of rivals.

Why the use of the past tense? Praxair no longer exists as a single entity after the business completed a $90 billion merger of equals with Linde in 2018. The mammoth deal has strengthened our investment outlook for the combined group, Linde, as it creates numerous opportunities to increase profitability and enjoy further synergies and value accretion for shareholders. Linde shares many of the underlying economics that Praxair enjoyed, including high switching costs, cementing the group's position as a global industrial gas leader in a hugely consolidated industry.

Efficient scale: Moving beyond Scalextric

Many motor-racing fans owned Scalextric when they were younger. Fast and frenetic competitions against friends and family on a miniature F1 track is about as close as most people ever get to owning their own team or participating in the real thing. Even for the world's largest car manufacturers, F1 is an exclusive guestlist.

The simple reason is that motor racing is extraordinarily expensive, creating barriers to entry that ensure the top manufacturers have a near monopoly on success. The costs are so high that less affluent teams must often purchase engines from established manufacturers such as Ferrari because they cannot afford to build their own. The Italian brand supplied its Ferrari 064 engine to both Alfa Romeo Racing and Haas F1 Team in 2019.

The biggest teams also receive the most lucrative sponsorships. Team sponsorship represented 44.7% of F1's 2018 revenues. It is hardly surprising that sponsors are keen to partner with motor-racing teams, with the sport reaching 490.2 million people across the world last year.[8] The Monaco Grand Prix, often considered the most prestigious race of the season, was watched by an audience of 110 million viewers.

Ferrari received an estimated $176.6 million from sponsors last season, dwarfing the $75 million Mercedes reportedly earned, despite the latter having won the last five Constructors' Championships.[9] Just one sponsor pays Ferrari approximately $50 million a year alone. Ferrari remains the marquee name in motor sports.

Advantages such as this mean a small selection of top teams has spent decades investing in research, development, infrastructure and training, creating an almost insurmountable barrier for new entrants. Since 1999, Brawn is the only team other than Mercedes, Red Bull, Ferrari and Renault to have won the Constructors' Championship. Brawn secured the title in 2009, the only season in which it competed before the team was bought and renamed Mercedes.

BMW, Toyota, Jaguar and Honda are all examples of big automobile brands that dipped their toe in the F1 waters during the 2000s, only to withdraw when the Global Financial Crisis led to many manufacturers tightening their (seat)belts.

BMW, Toyota, Jaguar and Honda are all examples of big automobile brands that dipped their toe in the F1 waters during the 2000s, only to withdraw when the Global Financial Crisis led to many manufacturers tightening their (seat)belts. Other teams have suffered even worse fates, such as Marussia, which went into administration after just three F1 seasons between 2012 and 2014.

Companies looking to make headway in the US cable broadband industry face similar problems, which is one of the key reasons we added Comcast to our portfolio. Nationwide, 98% of US homes have two or fewer broadband providers from which to choose if they want network speeds of 100MBps or more. Building alternative networks is a complex and costly endeavour, meaning existing market players like Comcast enjoy significant pricing power on a product that most Americans consider essential.

8. https://www.formula1.com/en/latest/article.formula-1s-tv-and-digital-audiences-grow-for-the-second-year-running.OqTPVNthtZKFbKqBaimKf.html

9. https://www.forbes.com/sites/csylt/2019/05/19/revealed-sponsors-fuel-formula-one-with-30-billion/#1eb3c9cb2416

By recognising the difference between short-term blips and long-term declines in performance, we aim to preserve and grow the wealth of our clients.

Technology upgrades, such as fibre-to-the-premises (FTTP) networks, have also encountered hefty upfront costs. Both Google Fibre and Verizon were forced to scale back FTTP rollout intentions due to poor returns on capital and other implementation setbacks. New market entrants need poles, ducts, properties and other infrastructure to build out networks. Much like Ferrari's engines, these essentials can be difficult to access and may come with a sizeable price tag through incumbents.

Looking ahead, Comcast's mix of business is moving away from video services as more customers adopt Netflix and similar streaming services. We expect substantial growth in the company's data and business divisions as a result – a shift that will not only raise margins, but also reduce the company's expenditure.

Reaching the chequered flag and beyond

We hope these examples of sustainable competitive advantage highlight some of the key principles behind our investment approach. The businesses we invest in often share our focus on long-term approaches that prioritise high and sustainable returns, while minimising risk.

And although it may seem counterintuitive, more isn't always better when it comes to sustainable competitive advantage. American academic Michael Porter wrote about the risks of being 'stuck in the middle' of multiple strategies in his 1985 book *Competitive Advantage: Creating and Sustaining Performance*.

'Becoming stuck in the middle is often a manifestation of a firm's unwillingness to make choices about how to compete. It tries for competitive advantage through every means and achieves none,' he stated.

His comments emphasise why we invest with conviction based on deep research and examining companies from every possible angle. Simply identifying the presence or absence of sustainable competitive advantages isn't enough. Our approach is more nuanced, balancing the relative importance of each moat for a particular sector, company and consumer base. We also continuously re-evaluate our investments to ensure they are maintaining their sustainable competitive advantages and act decisively to move out of companies that no longer meet our quality thresholds.

By recognising the difference between short-term blips and long-term declines in performance, we aim to preserve and grow the wealth of our clients. Williams was a dominant F1 force during the 1990s, yet its last championship victory was over 20 years ago. Ferrari may be experiencing a championship slump, but the brand's moats have ensured it has remained a competitive force in F1 from the sport's inception all the way through to today.

Conclusion

We'd like to end this quarterly newsletter with an anecdote that sums up our thinking on sustainable competitive advantage.

Last year, Tesla co-founder and CEO Elon Musk and Warren Buffett engaged in a war of words over the use of the term 'moat'. Musk claimed "moats are lame", arguing that the pace of innovation is the most important factor behind maintaining a competitive edge.

Buffett replied[10]: "Elon may turn things upside down in some areas. I don't think he'd want to take us on in candy."

He is referring to See's Candies, a company Buffett's Berkshire Hathaway bought in 1972 and still owns to this day. The confectioner's moat is an almost impenetrable brand reputation within the industry, especially on the US West Coast. In typical Musk style, he pledged to start a competitive candy company in response.

In a way, the good-natured skirmish represents a microcosm of the changes we have seen in the business landscape over recent years. Young, tech-savvy start-ups have looked to disrupt multiple industries and wrestle market share from well-established incumbents.

In this particular instance, and with respect to Mr Musk, our money is on Buffett. Literally. Berkshire Hathaway is a long-standing holding in our portfolio due to our confidence in the sustainable competitive advantage that Buffett has built at Berkshire Hathaway.

10. https://www.cnbc.com/2018/05/05/warren-buffett-responds-to-elon-musks-criticism-i-dont-think-hed-want-to-take-us-on-in-candy.html

Notes

At Rothschild & Co Wealth Management we offer an objective long-term perspective on investing, structuring and safeguarding assets, to preserve and grow our clients' wealth.

We provide a comprehensive range of services to some of the world's wealthiest and most successful families, entrepreneurs, foundations and charities.

In an environment where short-term thinking often dominates, our long-term perspective sets us apart. We believe preservation first is the right approach to managing wealth.